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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 157

HOLLYWOOD BASEBALL ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW, JURISDICTION, AND STATUTES INVOLVED

The opinions below, the basis of this Court's jurisdiction, and the statutes involved are adequately set forth in the petition.

QUESTION PRESENTED

Whether the court of appeals correctly held that amounts received by petitioner, a minor league baseball club, on player contract sales during the twelve-month period following adoption of a plan of complete liquidation, did not fall within the nonrecognition provisions of Section 337 of the Internal Revenue Code.

STATEMENT

Petitioner, a corporation, operated the "Hollywood Stars," a professional minor league baseball team in the Pacific Coast Baseball League. On December 17, 1957, its stockholders adopted a plan of complete liquidation. (Pet. App. C39.)

Among petitioner's assets at the time were contracts for the services of professional baseball players. Subsequent to December 17, 1957, and during petitioner's fiscal year ended October 31, 1958, petitioner sold at least six and possibly eight of these contracts[1] to the Pittsburgh Athletic Club and to its affiliate, the Columbus Baseball Club.[2] Petitioners profit from the eight sales was $117,000.[3]

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[1] The Commissioner contended below that two contracts were sold prior to adoption of the plan of liquidation and thus were not subject to nonrecognition treatment under Section 337 in any event. Since it was held that none of the contracts was subject to such treatment, this issue has never been resolved. (Pet. App. A27.)

[2] By agreement dated December 18, 1957, petitioner's remaining player contracts (approximately 28) were sold to the Salt Lake City Baseball Club, along with petitioner's franchise and equipment. The bulk sale of these player contracts is not here in issue.

[3] Two of the contracts, which had cost petitioner $1,500, were sold for $140,000 in installment payments. Petitioner received $50,000 of this amount in its fiscal year ended October 31, 1957, and reported the $50,000 as ordinary income for that year. A total of $27,000 was received by petitioner for the remaining six contracts which had cost it $17,650. The cost of the player contracts was deducted by petitioner as an item of current expense in the years the contracts were purchased. The $117,000 profit in the fiscal year 1958 was computed by adding $90,000 ($140,000 less $50,000) earned on the sale of the two contracts, and $27,000 from the sale of the six contracts. (Pet. App. A19, C39).

In order to prevent minor league clubs from holding on to a player indefinitely, the major leagues required each such club to sell each year to any major league club on demand, at least one player contract which previously had been assigned outright to that club by a major league club, and to sell the contracts of all players with five years or more of service to any major league club on demand. This arrangement, to which petitioner was a party, was known as the player draft. (Pet. App. C39.)

In addition to the league requirements, petitioner was party to so-called "working agreements" with major league clubs during relevant years, which provided, *inter alia*, that a major league club could select at any time any player's contract which petitioner owned. Petitioner was unable to compete with major league clubs in recruiting good young players. Consequently, unless it entered into such working agreements, it would have been unable to obtain quality players for its team. All such player contracts were owned by major league clubs and would be assigned to petitioner only under the conditions prescribed in the working agreements. (Pet. App. C39–C40.)

From 1948 through 1957, petitioner purchased 175 player contracts and sold 224 such contracts, or an average of over 22 contracts a year. Throughout this period, petitioner consistently reported income from these sales either as a part of its gross sales, or as other income from business operations. Consistently, petitioner also deducted against ordinary income the entire costs of acquiring player contracts and of training players. (Pet. App. A24–A26.)

Section 337 of the Internal Revenue Code provides for non-recognition of gain or loss on the sale or exchange of corporate property made within 12 months after adoption of a plan of complete liquidation, but specifically excludes from such treatment property held by the corporation "primarily for sale to customers in the ordinary course of its trade or business." On its fiscal 1958 income tax return, petitioner omitted from income the $117,000 it received on the sale of player contracts in that year ($90,000 from the sale of two players, and $27,000 from the sale of six players). It did so on the ground that the contracts were not held by it "primarily for sale" to customers in the ordinary course of business. The Commissioner asserted a deficiency and petitioner sought a redetermination in the Tax Court. That court held (Pet. App. A17–A33) that the player contracts were held primarily for sale and that the sales proceeds therefore were taxable. The court interpreted "primarily" to mean "substantially" or "essentially" rather than "of first importance" or "chiefly." The Ninth Circuit affirmed (Pet. App. B34–B36). On petition to this Court, the case was remanded for reconsideration in the light of this Court's holding in *Malat* v. *Riddell*, 383 U.S. 569, that "primarily for sale" as used in Section 1221 of the Code means "of first importance" or "principally," rather than "substantially" or "essentially" (383 U.S. 824).

On remand, the Tax Court found (Pet. App. C48) that (1) petitioner's motive of first importance was "to hold the contracts for sale" and (2) the contracts were petitioner's "stock in trade * * * held * * * prin-

cipally for sale to customers in the ordinary course of its trade or business" within the intendment of Section 337 and the meaning of *Malat* v. *Riddell*. On appeal, the Ninth Circuit reasoned (Pet. App. D50) that it would be unrealistic to say that, in fact, the contracts "were held * * * 'principally' for sale to customers, or that sale to such customers was 'of first importance'" when petitioner "sold its players because it had to agree to do so in order to be in business." The court agreed, however, that the sales were an integral part of petitioner's business and that the player contracts represented petitioner's raw materials or stock in trade. It accordingly affirmed the Tax Court decision as a correct application of the rationale of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, as approved in *Malat* v. *Riddell*, *supra*.

ARGUMENT

The decision below is correct. There is no conflict of decisions or other basis for further review.

1. Section 337 of the Code provides for nonrecognition of gain on the "sale or exchange" by a corporation of "property" during the 12-month period between the adoption and execution of a plan of complete liquidation. Excluded, however, from nonrecognition treatment (Section 337(b)(1)(A)) are gains or losses from the sale or exchange of—

> stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation * * * and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business.

The purpose of Section 337 is to eliminate the double incidence of capital gains taxation on a sale of assets by a liquidating corporation—once when the corporation sells its assets, and a second time on distribution of the proceeds to its shareholders in liquidation. Nonrecognition treatment thus is not available on sales of property in the ordinary course of business during the 12-month liquidation period, which would result in ordinary income if the corporation was not in the process of liquidating. H. Rep. No. 1337, 83d Cong., 2d Sess., p. A107; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 259; *Williamson* v. *United States*, 155 Ct. Cl. 279, 292 F. 2d 524; *Commissioner* v. *Kuckenberg*, 309 F. 2d 202 (C.A. 9); *Family Record Plan, Inc.* v. *Commissioner*, 309 F. 2d 208 (C.A. 9).

As the record indicates and the courts below found, petitioner was engaged both in presenting baseball games and in selling baseball player contracts. The latter aspect of its business was a regularly conducted operation. Sales were frequent and continuous, averaging 22 players a year, and they provided a normal source of business income over the years. During the course of its operations from 1948 through 1957, petitioner recognized these business facts and consistently reported gain on player contract sales as ordinary business income, taking ordinary deductions for the costs of acquiring the player contracts and training the players.

There is no basis under Section 337 for affording nonrecognition treatment to sales of these player contracts, which were made in the normal course of peti-

tioner's business during the 12-month liquidation period. The essential character of the contracts having been established in prior years, sales of the contracts during the liquidation period cannot be considered extraordinary sales. The decision below denying nonrecognition treatment thus is correct.

2. *Malat* v. *Riddell*, 383 U.S. 569, upon which petitioner relies (Pet. 11–14), does not require a different result. In that case, the taxpayers acquired property for the purpose of commercial development, intending a sale in bulk only in the event their plans fell through, and only then (*id.*, p. 571) "so they wouldn't get hurt." This Court held that the latter purpose would not be sufficient to require ordinary income treatment upon the sale of the property unless it was the principal purpose for which the property had been held. It may fairly be inferred from these facts that the only business contemplated involved the development of the property. The subsequent sale represented no more than a disposition of the property after the development plan had been abandoned.

Malat v. *Riddell* does not deal with the situation, common to contemporary business, where a company regularly engages both in selling an item and in leasing or exhibiting the same item. In such a situation, the taxpayer is engaged in two businesses, and the existence of the second business does not change the character of the income of the first—the regular income of both businesses is taxable as ordinary income. See *Recordak Corp.* v. *United States*, 163 Ct. Cl. 294, 325 F. 2d 460; *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2), certiorari denied, 375 U.S. 993;

Continental Can Co. v. *United States*, 422 F. 2d 405 (Ct. Cl.), taxpayer's petition for certiorari pending, No. 164, this Term.[4] Consequently, the distinctions drawn between a "substantial" and a "principal" purpose in *Malat* v. *Riddell* in the context of a single business do not afford a basis for treating the player contracts, found to have been regularly bought and sold to customers in one of petitioner's two businesses, as property entitled to nonrecognition treatment.

The findings of the Tax Court that petitioner engaged in regularly holding player contracts for sale to customers as part of its normal business operations (Pet. App. C40) are sufficient in this instance to support the conclusion that the contracts were property held primarily for sale to customers in the ordinary course of petitioner's trade or business. Cf. *Tomlinson* v. *Ducate*, 318 F. 2d 60 (C.A. 5). In bypassing the "primarily for sale" ground upon which the Tax Court principally relied, the Ninth Circuit appeared to assume that an asset may not be held primarily for sale if the fact that it is for sale is a matter of busi-

[4] As the Court of Claims stated in *Recordak*, *supra* (325 F. 2d, at 463), in such a setting—

> "primarily" invokes a contrast, not between selling and renting, but between selling in the ordinary course of business and selling outside of that normal course. Accordingly, if the entrepreneur holds out his wares either for sale or for rental, the taxation of his business gain from sales does not depend upon a comparison of sales to rentals in the particular year. *S.E.C. Corp.* v. *United States*, *supra*, 140 F. Supp. at 749. Regardless of that ratio, the goods are held "primarily for sale to customers in the ordinary course of * * * trade or business" because they are regularly offered for sale to customers as part of the normal operation of the enterprise. * * *

ness necessity. But the fact that petitioner may have held the contracts for sale because it was required to do so by the major leagues, rather than because it desired to do so, should make no difference. The only material question is whether the contracts were held for sale—not why. See *American Can Co.* v. *Commissioner, supra; Continental Can Co.* v. *United States, supra.* There can be no question on this record that the contracts were so held.

3. The decision below also may be supported under the tax benefit principle, as applied by this Court and other courts, the rationale of which is that if an item has previously served to offset ordinary income, its recoupment should be treated as a recovery of such income. *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 686, n. 5; *Alice Phelan Sullivan Corp.* v. *United States*, 180 Ct. Cl. 659, 663–666, 381 F. 2d 399, 401–403; *O'Meara* v. *Commissioner*, 8 T.C. 622, 634–635. Petitioner took deductions against ordinary income for all costs of acquiring player contracts and training players. Under its own theory of the case (Pet. App. B36), the player contracts "were generally sold at a loss when all of the expense of acquisition and development of players sold is considered * * *." [5] Thus, the entire proceeds of the player contract sales constituted a recoupment of prior deductions against ordinary in-

[5] Contrary to petitioner's contention (Pet. 13–14), the excess of the sales proceeds of the player contracts ($117,000) over the cost of the contracts ($22,150) does not represent merely an appreciation in value accrued over a substantial period of time. By petitioner's own admission, the appreciation resulted at least in part because it expended funds to train the players, which it deducted from ordinary income.

come, which should be taxed as ordinary income.[6] Cf. *Arrowsmith* v. *Commissioner*, 344 U.S. 6.

Application of the tax benefit principle in these circumstances does not depend on a finding that the item sold falls literally within the exceptions to the nonrecognition rule of Section 337(a) that are set out in Section 337(b)(1). Although Section 337(b) does not specifically refer to the tax benefit principle, the courts have consistently recognized that "there is no provision in the statute showing an intent to alter or bar the application in cases under § 337 of tax benefit principles fashioned under other provisions of the Code." *Commissioner* v. *Anders*, 414 F. 2d 1283, 1287 (C.A. 10), certiorari denied, 396 U.S. 958; see also *West Seattle National Bank of Seattle* v. *Commissioner*, 288 F. 2d 47 (C.A. 9); *Citizens Federal S. & L. Ass'n of Cleveland* v. *United States*, 154 Ct. Cl. 305, 311–315, 290 F. 2d 932, 936–938; *Hallcraft Homes, Inc.* v. *Commissioner*, 336 F. 2d 701 (C.A. 9); 1 Mertens, *Law of Federal Income Taxation*, Sec. 7.34; Rev. Rul. 61–214, 1961–2 Cum. Bull. 60. Petitioner's sales of player contracts thus are subject to ordinary income treatment, whether or not the Tax Court was correct in concluding (Pet. App. C40) that the contracts were petitioner's stock in trade and were held principally for sale to customers in the ordinary course of its trade or business.

4. For the reasons stated above, the court of appeals need not have reached *Corn Products Co.* v.

[6] *Nash* v. *United States*, No. 678, 1969 Term, decided May 18, 1970, is not to the contrary. In that case, unlike this one, there was no "recovery" of the costs previously deducted from ordinary income.

Commissioner, 350 U.S. 46, in order to decide this case properly. However, its reliance on *Corn Products* in the particular circumstances of this case was entirely correct.

Section 1221(1) of the Code (Pet. 4), the substantially unchanged successor provision to Section 117 of the 1939 Code, excludes certain property from the definition of the term "capital asset." Section 337(b)(1)(A), in virtually identical language, excepts that property from the nonrecognition rule of Section 337(a). In *Corn Products*, this Court held that sales of corn futures by a manufacturer of corn products, which were made to insure against price increases in the raw materials used in the manufacturer's normal business operations, resulted in ordinary income rather than capital gain. The Court reasoned that although the futures may not have fallen within the literal language of any of the exclusions from the capital asset definition, the statutory language should not be so broadly applied (350 U.S. at p. 52)—

> as to defeat rather than further the purpose of Congress. *Burnet* v. *Harmel*, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income. * * *

Petitioner here urges that its profits from player contract sales should not be recognized because the contracts did not fall within the essentially identical

literal exclusions of Section 337(b)(1)(A). Although Sections 1221 and 337 may not be parallel in every respect (see discussion, Pet. App. D56–D59; compare *Coast Coil Co.* v. *Commissioner*, 50 T.C. 528, affirmed *per curiam*, 422 F. 2d 402 (C.A. 9), and *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 35 (C.A. 4)), neither capital gains treatment nor nonrecognition is intended to be afforded to assets which are the subject of regular sales in a taxpayer's normal business operations. The court below thus did not err in relying on the rationale of *Corn Products* after finding (Pet. App. D62) that (1) the income plainly was of a nature which arose from normal business operations and (2) the player contracts were, in effect, the "raw material" or "stock in trade" of the business. This very limited and classic application of *Corn Products* does not extend its holding beyond its own facts—regular sales of assets in the course of a business which essentially represent the raw materials of that business—in *Corn Products*, the corn; in this case, the baseball players.

The issue here is to be contrasted with the question presented in *Waterman, Largen & Co.* v. *United States*, 189 Ct. Cl. 364, 419 F. 2d 845, and *Steadman* v. *Commissioner*, 424 F. 2d 1 (C.A. 6), in which we shall shortly file petitions for writs of certiorari. The question in the cited cases is whether, under the *Corn Products* rationale, a taxpayer which purchases the stock of a corporation, in order to retain the corporation as a client, is entitled to treat a loss on the sale or worthlessness of the stock as an ordinary loss. Unlike the instant case, which arises under Section 337, *Waterman*, *Largen* and *Steadman* involve the capital asset definition of Section 1221 (formerly Section 117), as did *Corn Products*. Moreover, the question raised in those cases has been the subject of a wide variance of opinion in the lower courts.

Petitioner argues (Pet. 14–15) that the application of the *Corn Products* doctrine to Section 1231 depreciable assets creates an issue worthy of this Court's review. But this question is extraneous to the facts here, since, under the method of accounting used by petitioner, the player contracts were not treated as depreciable assets, but rather as currently deductible expenses. Moreover, the question of the tax consequences on a sale of a depreciable asset—whether or not in connection with a Section 337 liquidation—has in large part been resolved by the enactment in 1962 of the recapture of depreciation provision now found in Section 1245 of the Code. That provision requires that gain on the sale of such property be treated as ordinary income to the extent of depreciation deductions previously taken. Apart from this, as the court of appeals observed (Pet. App. D55–56), application of the *Corn Products* doctrine to depreciable assets involves no great departure from *Corn Products* itself. It merely reflects the policy underlying both Sections 1221 and 1231, that preferential treatment is not to be accorded normal business profits and losses.

5. Finally, there is no conflict of decisions to warrant review by this Court. *Hillard* v. *Commissioner*, 281 F. 2d 279 (C.A. 5), and *Philber Equipment Corp.*

The issue here, on the other hand, arises on relatively unusual facts, and, as we have shown, the *Corn Products* principle is not critical to the outcome in any event.

The contention (Pet. 15) that the decision below has the effect of reading Sections 337 and 1231 out of the Code is without merit. Those provisions are fully applicable to sales or exchanges of property which do not result in a normal source of business income, and nothing in the decision below affects their proper operation.

v. Commissioner, 237 F. 2d 129 (C.A. 3), discussed by petitioner (Pet. 8–10), both involved sales of property—motor vehicles—by a taxpayer engaged in the vehicle leasing business. The courts, recognizing that the sales activities were merely part of the last phase of a cycle in the use of the vehicles—the replacement or sale of equipment no longer useful in the business—concluded that the vehicles were not held by the taxpayer primarily for sale to its customers in the ordinary course of business. In contrast, as we have shown, petitioner was engaged in two businesses. In its selling business, it held player contracts for sale to customers from the moment of their acquisition and indeed was required to do so. This is not a case of a disposal of players who were no longer fit to play baseball for petitioner's team, but one of regular sales in the normal course of business of petitioner's most valuable and highly skilled players.

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[1] Like *Hilliard* and *Philber Municipal Bond Corporation* v. *Commissioner*, 341 F. 2d 683 (C.A. 8) (Pet. 10), is not in conflict with the decision below. In that case, the court simply reaffirmed that "primarily for sale" means "principally" or "of first importance." Moreover, in none of these cases was *Corn Products* discussed or interpreted in a manner that conflicts with the decision of the Ninth Circuit here. As for the Court of Claims' decisions with which petitioner appears to assert conflict (Pet. 10), the court of appeals correctly pointed out (Pet. App. D53–D54) that in each of them the question whether *Corn Products* applies to Section 1231 assets was reserved.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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